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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

*Iceland: The Economic Importance
Of The US Military Presence*

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
October 1971

INTELLIGENCE MEMORANDUM

**ICELAND: THE ECONOMIC IMPORTANCE
OF THE US MILITARY PRESENCE**

Introduction

1. Under a 1951 agreement, the United States operates a NATO-related base at Keflavik. The base's location enables the US military to monitor Soviet submarines entering the Atlantic via the Norwegian Sea. In June 1971 a coalition of center-left parties took control of the Icelandic government and immediately announced its intention to study the feasibility of US withdrawal within four years. This memorandum explores the contributions that the 3,000-man base makes to Iceland's economy, assesses the probable economic impact should it be closed, and analyzes the extent of economic pressures on the coalition government to maintain the US presence.

Discussion

Background

2. Despite a paucity of natural resources, a small domestic market of just over 200,000 people, and a remote location, Iceland has made substantial strides since World War II in establishing a modern economy. Through a vigorous foreign trade - amounting to about 75% of gross national product (GNP) - Icelanders now have a per capita income of about \$2,000 and a standard of living commensurate with most of the industrialized West. Iceland's only major resources are its large hydroelectric potential and some thermal springs, a small but highly skilled labor force, and, most importantly, rich fishing grounds in the surrounding seas.

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

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3. After a decade of economic growth, Iceland's economic prosperity still largely depends on the fishing industry, which contributes approximately 30% of GNP and industrial employment and about 80% of total commodity exports. Export receipts from fish products - \$123 million in 1970 - cover 78% of total annual imports. Thus the industry is of critical importance to Iceland.

Recent Economic Growth

4. The real growth of Iceland's economy during 1961-66 averaged 7.4% annually (see Table 1). A very great increase in the fish catch,

Table 1

Gross National Product

<u>Year</u>	<u>GNP a/ (Million 1960 Kronur)</u>	<u>Percentage Change</u>
1960	8,378	
1963	10,076	20.3
1964	11,059	9.8
1965	11,847	7.1
1966	12,893	8.8
1967	12,613	-2.1
1968	11,860	-6.0
1969	12,100	2.0
1970 b/	12,947	7.0

a. There have been two devaluations of the krona in the 1960-70 period: 24.6% in 1967 and 35.2% in 1968. The par value of the krona is 88.1 kronur to US \$1. The krona has been floating since 23 August 1971 resulting in a slight appreciation relative to the dollar.

b. Estimated.

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reflecting largely new and better equipment, underlay this expansion. Industrial production, excluding fish processing, also rose rapidly in the early 1960s, but rapidly rising wages and stronger foreign competition, resulting from a more liberal import policy, led to some slowdown by mid-decade. Indeed, the economy continually suffered from a strong upward movement in costs and prices, reflecting excessive demand pressures from wage and other income increases throughout the period (see Table 2).

Table 2
Consumer Price Index

<u>Year</u>	<u>Index</u> <u>(1963 = 100)</u>	<u>Annual</u> <u>Increase</u>
1964	119	19.0
1965	127	6.7
1966	141	11.0
1967	146	3.5
1968	165	13.0
1969	201	21.8
1970	228	13.4
1971	243	6.6 <u>a/</u>

a. As of June 1971.

Nevertheless, the country's balance-of-payments position remained relatively strong, with official international reserves increasing from \$12.3 million in 1960 to \$58.0 million in 1966.

5. In 1967 and 1968, however, the economy suffered serious setbacks. GNP fell by 2.1% in 1967 and by 6.0% in 1968. This was accompanied by large current-account deficits - \$52.3 million in 1967 and \$46.0 million in 1968 - mainly because of a nearly complete failure of the herring catch and by declines averaging about 10% in export prices of fish and fish products. In addition, exports of dried fish to Nigeria - about 5% of Iceland's total fish exports - were disrupted by the civil war

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there. Thus the total export value of fish and fish products fell by 45% in the two-year period. Foreign reserves dropped to \$28.6 million by the end of 1968. During this period, serious balance-of-payments problems forced two krona devaluations - by 24.6% in November 1967 following the sterling devaluation and again by 35.2% in November 1968.

6. The trend was reversed in 1969 when real GNP rose about 2%. This was followed by a 7% increase in 1970 owing to sharp increases in fish catches, fish prices, and the export of aluminum and diatomite (the raw material from which filters are made). The 1967 and 1968 devaluations stimulated greater fishing efforts and greater processing of the catch and also encouraged other exports. Moreover, programs for diversifying the economy and strengthening the industrial sector were implemented in 1969 and 1970. Imports contracted in 1968 and 1969 in response to the devaluations, and foreign exchange reserves again rose, reaching \$54.1 million at the end of 1970.

Postwar Political-Military Developments

7. Iceland's relationship with NATO has traditionally been reserved. Iceland joined NATO in 1949 with the understanding that no such forces would be stationed there in peacetime. Nevertheless, spurred on by the implications of the Korean War for security and world peace, Reykjavik signed an agreement with the United States on behalf of NATO in 1951 that allowed a US military presence; most of the population has never reconciled itself to this concession. In 1956 a new center-left government composed of the Progressive Party, Social Democrats, and the Labor Alliance (Communists) requested revision of the 1951 agreement to force withdrawal of the US contingent. This request, however, was dropped at the time of the Hungarian Revolution.

8. In mid-1971, another center-left coalition - Progressive (farmers') Party, People's Alliance (Communists), and the Liberal Left - returned to power after 13 years in opposition. Their campaign litany included a call for the withdrawal of American servicemen - the Icelandic Defense Force - from Keflavik. After assuming office on 14 July, the government announced a study of the overall importance of the base to Iceland, including consideration of the economic costs resulting from a US withdrawal.

The Economic Impact of the US Military Presence

9. The US-manned NATO base at Keflavik contributes about 5% to Iceland's GNP through (a) direct base expenditures, (b) spending by US personnel and their families, and (c) the multiplier effect of secondary rounds of spending. It also makes a net contribution to Iceland's foreign exchange earnings.

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10. In 1970, operating expenditures of the base represented 2.9% of Iceland's GNP, compared with 3.1% in 1969 and 4.8% in 1968. The largest share - 39% - was construction costs, which equaled approximately one-tenth of total construction expenditures in the country (see Table 3). Salaries to Icelandic employees accounted for about another 22% of base expenditures. These employees, about 734 in mid-1971, represent less than 1% of the total labor force. Contractors working for the base employed an additional 337.

11. The US military presence also contributes to the Icelandic GNP through the local expenditures of US military and civilian personnel. In US fiscal year 1971 the military payroll was about \$21 million and the civilian payroll an additional \$1.8 million. Conditions in Iceland are not conducive to US personnel spending large sums locally. Single men below the rank of Army captain are subject to a stringent curfew. Only about 10% of US personnel live off base. Thus the estimated contribution to GNP from this source was only about \$2 million in calendar year 1970, or about 0.5% of GNP.

12. The total expenditures associated with the US military presence generate additional income through the subsequent spending by the recipients of sums paid for locally produced goods and services. This process may add another \$7 million or so to GNP.* Thus the total contribution of the base was about \$21 million, or some 5% of Iceland's 1970 GNP.

13. The installation has been providing direct foreign exchange receipts averaging about \$12 million a year. In addition, US personnel provide another \$2 million. After deducting goods, including petroleum, imported for US base and personnel use, net direct foreign exchange earnings in 1969 were about \$11 million, or some 6% of total current receipts. While the importance of these receipts has been declining over the decade, they still mean the difference between a surplus and a deficit in Iceland's current external account (see Table 4).

Were the US Base to Be Withdrawn

14. The time frame of withdrawal is central to determining the economic significance of the loss of the income-generating activities of the US military presence. Over time, Iceland's economy will grow, thereby affecting the relative position of the base.

* This assumes a multiplier of 1.5 - in other words, for each dollar of direct expenditures, one-half dollar of indirect expenditures on domestic goods and services is generated. The small value of the multiplier is the result of the fact that a large share of expenditures goes for imported goods.

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Table 3

Major Categories of Base Expenditures at Keflavik a/
by Fiscal Year

	Million US \$			
	1970 <u>b/</u>	1971 <u>c/</u>	1972 <u>c/</u>	1973 <u>c/</u>
Total <u>d/</u>	12.0	16.3	17.7	20.5
Of which:				
Construction and repair	4.7	6.3	6.8	9.6
Salaries to Icelandic employees	2.6	4.3	5.0	5.0
Purchase of goods and services	1.4	2.0	2.0	2.0
Transportation of material	1.2	1.6	1.7	1.7

a. The payroll for US military and civilian personnel is not included.

b. Actual.

c. Projected.

d. Related to receipts from defense force in Table 4.

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Table 4
Iceland's Balance of Payments

	Million US \$						
	1960	1965	1966	1967	1968	1969 ^{a/}	1970 ^{b/}
Current account							
Total receipts	97.7	194.0	211.4	179.9	155.9	183.3	N.A.
Of which:							
Exports (f.o.b.)	67.1	129.3	139.1	98.8	82.8	106.9	146.6
Receipts from defense force ^{c/}	10.4	8.2	10.4	15.2	10.9	11.3	11.9
Tourism	0.6	2.4	2.7	2.9	3.1	3.6	4.5
Total expenditures	108.6	188.3	218.9	232.2	201.9	178.9	N.A.
Of which:							
Imports (f.o.b.)	81.9	137.3	159.4	162.4	138.2	123.3	157.5
Imports for defense force ^{d/}	1.9	1.0	0.8	1.1	1.5	1.4	N.A.
Balance on current account	-10.9	5.7	-7.5	-52.3	-46.0	4.4	9.0
Direct net contribution of US-NATO base ^{e/}	8.5	7.2	9.6	14.1	9.4	9.9	N.A.

a. Preliminary.

b. Estimated.

c. The entries represent receipts from the US military forces in Iceland for construction, for purchase of petroleum from Icelandic companies, and for other purposes.

d. Supplies for defense forces include oil imported for resale to US military forces, which are included in receipts from the defense force.

e. Receipts from the defense force minus imports for defense force equals direct net contribution.

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15. The outlook for Iceland's economy is favorable. In recent years, important structural changes have decreased dependence on herring and market conditions. The fishing industry has begun to exploit alternative fish species; a combination of cod, haddock, and ocean perch catches has replaced herring in importance, which in turn has increased the industry's stability. The improved economic position is also the result of policies to modernize and expand manufacturing industry by establishing some large undertakings and supporting infrastructure, including a large hydroelectric power facility, the Swiss-financed Straumsvik aluminum smelter, and a diatomite plant. A member of the European Free Trade Association (EFTA) since March 1970, Iceland is negotiating for an agreement with the European Communities to assure a continued growth in its trade with the EC countries.

16. This optimistic forecast, however, is subject to uncertainty. With the economy still heavily dependent on fish, a product whose world market prices fluctuate sharply, export earnings could fall, although they are unlikely to do so in the next 2 or 3 years. In addition, Iceland has a history of inflationary wage-price spirals. Much depends on what happens when the current wage-price freeze is lifted on 31 December.

Withdrawal: One-Shot vs Phased-Out

17. An immediate withdrawal would cause GNP to decline about 5% in real terms - equivalent to less than one year's average growth for the economy. Moreover, the importance of the base to the economy probably will not decrease significantly in the next few years. Base expenditures for construction will grow, but so will the rest of the economy. A gradual withdrawal would, of course, reduce the economic impact considerably.

18. It is unlikely that a military withdrawal would generate significant unemployment. In September 1970, unemployment was down to 0.4% of the labor force, and overtime work, part-time, and double employment were prevalent. Several manufacturing and construction projects are planned, including a chemicals complex and an oil refinery. Iceland's small labor force thus can expect to be in great demand in an expanding economy.

19. Withdrawal could create balance-of-payments problems that would force an economic slowdown. The more rapid the rate of economic expansion the greater the increase in imports. With exports largely determined by factors outside Iceland's control, an attempt to compensate for the effect of base withdrawal on domestic incomes could lead to growing trade deficits. However, short-run balance-of-payments prospects are good.

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Marine biologists predict a modest increase in fish catch during the next few years, and industrial exports are growing rapidly. Even though Iceland's current account would worsen with withdrawal, the capital account is traditionally in surplus and should remain so as inflows for industrial projects increase over the next several years. In addition, Iceland can draw on the record amount of foreign exchange reserves.

Conclusions

20. The Keflavik base contributes about 5% of Iceland's GNP and about 6% of its foreign exchange earnings. While an immediate withdrawal would greatly reduce economic growth for a year or so, a phased withdrawal would have little impact on overall incomes and employment, unless the balance of payments was already under strain. Balance-of-payments prospects for the next 2 or 3 years are favorable, however, and Iceland currently has the highest level of reserves since World War II. Iceland, moreover, has had to adjust in the past to declines in export earnings and, at worse, loss of earnings from the base would be very small compared to the 40% drop in exports during 1967-68. The economic problems caused by loss of the Keflavik base, thus, would be manageable in any event.

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